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July 17, 2000

TO INTERESTED PARTIES:

JAMES E. SPEED
Executive Director

REVISION OF ASSESSORS' HANDBOOK SECTION 541
ASSESSMENT OF PUBLIC UTILITIES AND RAILROADS

Enclosed is a matrix summarizing all interested parties comments received regarding the first draft of revised Assessors' Handbook Section 541, *Assessment of Public Utilities and Railroads*, and staff's response. Minor changes relating to grammar, punctuation, and spelling are not shown.

The project schedule indicated that a second draft of the handbook would be distributed with the matrix. The second draft will not be prepared until after the interested parties meeting, however, because of the relatively small number and limited extent of changes to the first draft.

On August 22, 2000, staff will hold a meeting with interested parties to discuss proposed changes identified on the matrix. The purpose of the meeting is to reach as much agreement as possible about the final language of the handbook. Interested parties should bring copies of the previously mailed first draft and the enclosed matrix. The meeting is scheduled from 9:30 a.m. to 2:30 p.m. in Room 122, Board of Equalization, 450 N Street, Sacramento.

Shortly after the meeting, staff will post a draft of the handbook on the Board's Web site that includes, in strikeout-underline format, all agreed-upon changes to the first draft from the August 22 meeting and all changes relating to grammar, punctuation, and spelling. The revised handbook and any unresolved wording differences will be presented to the Property Tax Committee at its meeting on November 1, 2000. The deadline for interested parties to submit alternative text concerning pending issues is September 29, 2000.

Please submit comments regarding the enclosed matrix to either Paul Lane or Benjamin Tang, Policy, Planning, and Standards Division. If you have any questions, please contact Mr. Lane at (916) 324-5828 (plane@boe.ca.gov) or Mr. Tang at (916) 324-2720 (btang@boe.ca.gov).

Sincerely,

/s/ Richard C. Johnson

Richard C. Johnson
Deputy Director
Property Taxes Department

RCJ:bt
Enclosure

ASSESSORS' HANDBOOK SECTION 541
ASSESSMENT OF PUBLIC UTILITIES AND RAILROADS
ALTERNATIVE LANGUAGE

ITEM NO.	PAGE/LINE REFERENCE		SOURCE	PROPOSED LANGUAGE	SBE STAFF POSITION
1.	All	All	SBE staff		[Note: Nonsubstantive changes to correct grammar, punctuation, or spelling are not shown in the matrix.]
2.	4	7	Western States Assoc. of Tax Reps. (WSATR)	Comment. No alternative text provided. Not sure the reference to "paragraph (2)" is proper. The material to which this refers is labeled (2) but is part of the 1 st line of the 1 st paragraph of section 19.	Proposed staff revision: For example, paragraph (2) of section 19 of article XIII grants....
3.	4	8	WSATR	Revise paragraph: For example, paragraph (2) of section 19 of article XIII grants the Board jurisdiction to assess "property ", except franchises, owned or used by regulated railway, telegraph, or telephone companies, or car companies operating on railways in the State, and companies transmitting or selling gas or electricity."	Proposed staff revision (correct quotation): ... "property, except franchises, owned or used by regulated railway, telegraph, or telephone companies, car companies operating on railways in the State, and companies transmitting or selling gas or electricity."
4.	4	10:13	WSATR	Comment. No alternative text provided. Appears that the draft expands the scope of jurisdiction to gas/electric marketers who merely sell gas/electricity but do not take part in the delivery of these products. For example, are the computers located in CA which are owned by a retail marketer now subject to Board – not local – assessment?	Proposed staff revision: In this passage, the adjective "regulated" does not grammatically modify "car companies" or "companies transmitting gas or electricity"; thus the Board's jurisdiction <u>may</u> extends to car companies and companies transmitting or selling gas or electricity whether or not such companies are regulated.
5.	4	19:28	WSATR	Revise paragraph: Until recent years, many companies subject to state assessment were also rate-regulated, meaning that in exchange for certain monopoly rights over a designated franchise or service area, the companies were limited in the rates they could charge. Other companies were, and some still are, rate-base/rate-of-return regulated, meaning that the rates, or income, that regulators allow such companies to earn are designed to cover <u>operating, maintenance, administrative, and general costs, depreciation, taxes and a CPUC-determined rate-of-return on rate base. Rate base is defined as historical cost less accumulated depreciation less the accumulated deferred federal income tax reserve less investment tax credits (ITC) plus working capital costs, including taxes and depreciation, and also provide a "fair" rate of return on investment, often as measured by a fair rate of return on rate base. Rate base, with some modifications, is essentially the book, or accounting, value of the company's assets used in providing service. With the deregulation of several industries in</u>	Not accepted (The original text is more general and thus avoids being industry specific).

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				<p>recent years, however, the majority of state assessees are no longer subject to rate regulation or rate base/rate of return regulation.</p> <p><u>Pursuant to deregulation, many state assessees (in terms of the number of companies) are no longer rate base/rate-of-return regulated.</u></p>	
6.	8	20:30	WSATR	<p>Revise paragraph:</p> <p>To address the jurisdictional implications of electric industry restructuring, the Board adopted rule 905. Rule 905 limits the Board's assessment jurisdiction in <u>regard to electric generation facilities</u>. It states:</p> <p style="padding-left: 40px;"><u>An electric generation facility shall be state assessed property for purposes of article XIII, section 19 of the California Constitution if: (1) the facility was constructed pursuant to a certificate of public convenience and necessity issued by the California Public Utilities Commission to the company that presently owns the facility; or (2) the company owning the facility is a state assessee for reasons other than its ownership of the generation facility or its ownership of pipelines, flumes, canals, ditches, or aqueducts lying within two or more counties.</u></p> <p>Therefore, there has been a shift from state to local assessment of some electric generation facilities. which (1) the electric generation facility was constructed pursuant to a certificate of public convenience and necessity issued by the CPUC, or (2) the company owning the facility is a state assessee for other reasons¹². As a result of rule 905, there has been a shift from state to local assessment of some electric generation facilities.</p> <p>These facilities were assessed by the Board in 1998 but were subsequently sold to independent power companies that do not come under Board assessment jurisdiction under the provisions of rule 905. About seven investor-owned public utilities (with both power generation and distribution facilities) remain subject to rate-regulation and are still considered "public utilities" by the CPUC. Under rule 905, the property of these companies continues to be assessed by the Board.</p>	Accept proposed revision.

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7.	10	4:6	WSATR	Revise paragraph: 5. <u>For unitary and nonunitary values determined by the Board,</u> The state assessee is given an opportunity to petition the Board for review of and to appeal the assessed value and claim a refund. (Chapter 6 discusses the appeals process for state assessments.)	Proposed staff revision: 5. <u>For unitary and nonunitary values determined by</u> The state assessee is given an opportunity to petition <u>the Board for review of an to appeal the assessed value and claim a refund, the state assessee may file a petition for reassessment.</u> (Chapter 6 discusses the appeals process for state assessment.)
8.	11	22:28	WSATR	Revise quote: Except as is otherwise provided in Section 110.1, "full cash value" or "fair market value" means the amount of cash or its equivalent that property would bring if exposed for sale in the open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other, and both the buyer and the seller have knowledge of all the uses and purposes to which the property is adapted and for which it is capable of being used, and of the enforceable restrictions upon those uses and purposes.	Accept proposed revision (corrects the quotation by adding commas after "other" and "used," respectively).
9.	12	5	WSATR	Comment. No alternative text provided. "have sufficient of time or analyze and bid on the property," Not clear what this means.	Proposed staff revision: This means that all potential buyers <u>are aware that the property is for sale and</u> have sufficient time and opportunity or analyze and bid on the property <u>to present their offers.</u>
10.	12	19:24	WSATR	Revise paragraph: <u>Pursuant to Subdivision (d), "the value of intangible assets and rights relating to the going concern value of a business using taxable property shall not enhance the value of taxable property."</u> Subdivision (e) notes that "taxable property may be assessed and Subdivisions (d), (e), and (f) of section 110 express the concept that intangible assets and rights relating to the operations of a business may not enhance the value of taxable property. While intangible assets and rights are not themselves taxable, property that is otherwise taxable may be valued by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use." As will be discussed in greater detail later, these subdivisions are particularly pertinent to the state assessment. ¹⁶	Proposed staff revision (from AH 501, to replace existing lines 19:24): Subdivisions (d), (e), and (f) of section 110 express the concept that intangible assets and rights relating to the operations of a business may not enhance the value of taxable property. While intangible assets and rights are not themselves taxable, property that is otherwise taxable may be valued by assuming the presence of intangible assets or rights necessary to put the property to beneficial or productive use. As will be discussed in greater detail later, these subdivisions are particularly pertinent to the state assessment. <u>Subdivisions (d), (e), and (f) of section 110 address the treatment of intangible assets and rights. Subdivision (d) provides that: (1) the value of intangible assets and rights relating to the going concern value of a business using taxable property shall not enhance or be reflected in the value of the taxable property; (2) if</u>

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				<p><u>the principle of unit valuation is used to value properties that are operated as a unit, then the fair market value of the taxable property contained within the unit shall be determined by removing from the value of the unit the fair market value of the intangible assets and rights contained within the unit; and (3) the exclusive nature of a concession, franchise, or similar agreement is an intangible asset that shall not enhance the value of taxable property, including real property.</u></p> <p><u>However, in applying the above principles, the Legislature stated at the beginning of subdivision (d) that its provisions are expressly subject to the language in subdivision (e). Subdivision (e) states: "Taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the property to beneficial or productive use."</u></p> <p><u>Finally, subdivision (f) of section 110 provides that for the purpose of determining "full cash value" or "fair market value," any intangible attributes of real property shall be reflected in the value of the real property, and that these attributes include zoning, location, and other such attributes that relate directly to the real property involved.</u></p>
11.	13	11:17	WSATR	<p>Revise quote:</p> <p><i>In ITT World Communications, Inc. v. City and County of San Francisco</i>, the California Supreme Court ruled that article XIII A's assessment rollback, its 2 percent limit on annual assessment growth, and its limit on current market value assessment only upon a change in ownership and new construction did not apply to state-assessed property, only to locally assessed property.¹⁸ As a result, taxable property in California is now generally split into two major categories: locally assessed property subject to the property tax value assessment limitations of article XIII A and state-assessed property not subject to <u>the value assessment limitations of article XIII A.</u></p>
				<p>Proposed staff revision:</p> <p><i>In ITT World Communications, Inc. v. City and County of San Francisco</i>, the California Supreme Court ruled that article XIII A's assessment rollback, its 2 percent limit on annual assessment growth, and its limit on current market value assessment only upon a change in ownership and or new construction did not apply to state-assessed property, only to locally assessed property.¹⁸ As a result, taxable property in California is now generally split into two major categories: locally assessed property subject to the property tax <u>assessment</u> limitations of article XIII A and state-assessed property not subject to <u>the assessment limitations of article XIII A.</u></p>
12.	15	12:17	O'Melveny & Myers L.L.P.	<p>Revise paragraph:</p> <p>The principle of unit valuation holds, in essence, that a collection</p>
				<p>Proposed staff revision:</p> <p>The principle of unit valuation holds, in essence, that a collection</p>

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				<p>of tangible assets functioning as an operating unit should be valued as a whole, without reference to the separate values of the assets constituting the operating unit. A unit valuation is contrasted with a "summation valuation," in which the component parts of an operating unit are valued separately and summed to estimate the value of the whole. The fundamental premise of unit valuation is that a synergistic value is created when individual assets are combined into an operating unit. <u>Under the principle of unit valuation, the Board is authorized to recognize the entire operating unit as the proper appraisal unit for certain property, thereby recognizing the high degree of functional and economic integration of such property. When the Board appraises a telephone company, for example, the appraisal unit comprises all of the operating property of the telephone company.</u></p>	<p>of tangible assets functioning as an operating unit should be valued as a whole, without reference to the separate values of the assets constituting the operating unit. A unit valuation is contrasted with a "summation valuation," in which the component parts of an operating unit are valued separately and summed to estimate the value of the whole. The fundamental premise of unit valuation is that a synergistic value is created when individual assets are combined into an operating unit. Under the principle of unit valuation, the Board is <u>may</u> authorized to recognize the entire operating unit as the proper appraisal unit for certain property, thus recognizing the high degree of functional and economic integration of such property. When the Board appraises a telephone company, for example, the appraisal unit comprises all of the operating property of the telephone company.</p>
13.	16 & 17	16:34 & 1:2	O'Melveny & Myers L.L.P.	<p>Delete paragraphs:</p> <p>In the valuation of public utility property, for which market activity is frequently limited, the appraiser must hypothesize regarding the unit of property that <i>would</i> be traded if an active market did exist. One approach is to make the individual items that constitute the entire utility system, for which sales data are readily available, the basic units of valuation. This, as noted, is the summation approach, and the value of the system as a whole would then be summation of the separate market values of these items.</p> <p>According to the principle of unit valuation, however, this approach would be incorrect. It is incorrect because once the individual items have been combined into a system they have, in effect, been transformed into a different type of property, a type of property in which the individual items constituting the system no longer have separate market values. And,</p> <p style="padding-left: 40px;">In this sense, there is only a difference of degree between a house and a public utility enterprise....At the time of the purchase of each item the price of the item is equivalent to its market value. But when all the materials have been combined, it is meaningless to talk about the value of the wood and the value of the electrical fixtures and the value of all the other</p>	Accept proposed revision.

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				<p>individual items and then say the value of the whole is equal to the sum of the values of these individual parts.... Each loses its physical identity in the act of installation and a mere desire to [separately] value the property does not restore this identity. There are probably few who would raise serious objections to valuing a house as an entity.... Yet there does seem to be a certain reluctance to apply the same principles to a large industrial enterprise or a public utility.²⁴</p> <hr/> <p>²⁴ Senate Interim Committee Report, 38.</p>	
14.	16	6	WSATR	<p>Delete footnote:</p> <p>Footnote 22 – Section 51 relates to adjustments to base year values for purposes of subdivision (b) of Section 2 of Article XIII A. Therefore, subdivision (d) of section 51 does not apply to other sections. What is stated in the text is generally accepted. Recommend removing the footnote.</p>	Accept proposed revision.
15.	18	17	WSATR	<p>Revise quote:</p> <p>One of the primary objectives of the system of unit taxation of public utility property is to ascertain and reach with the taxing power the entire real value of such property. [Citations] It has long been recognized that "public utility property cannot be regarded as merely land, buildings, and other assets. Rather, its value depends on the interrelation and operation of the entire utility as a unit. Many of the separate assets would be practically valueless without the rest of the system. Ten miles of telephone wire or one specially designed turbine engine would have a questionable value, other than as scrap, without the benefit of the rest of the system as a whole. [Citation] Unit taxation prevents real but intangible <u>value</u> from escaping assessment and taxation by treating public utility property</p>	Accept proposed revision (corrects quotation).

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			as a whole, undifferentiated into separate assets (land, buildings, vehicles, etc.) or even separate kinds of assets (realty or personalty).	
16.	23:45	SBE staff	<p>[Explanatory note from staff: WSATR proposes what is essentially a complete rewrite of Chapter 4, “Unitary Value Indicators.” Their rewrite—with the exception of text about the stock and debt approach—replaces the existing text with material directly from the Board’s <i>Unitary Valuation Methods</i>, for purposes of consistency.</p> <p>More specifically, WSATR’s proposed rewrite includes (1) the material in Addendum A to this matrix (which would replace everything in existing Chapter 4 except the material on stock and debt) and (2) a revised version of the material on stock and debt based on the original draft with proposed revisions described in matrix items 18 through 21 below.</p> <p>In response, staff proposes a treatment that is much shorter than its original and also avoids the redundancy of repeating <i>Unitary Valuation Methods</i> here. Staff’s revised version recites the approaches to value and then refers the reader to <i>Unitary Valuation Methods</i> and other sources. The text concerning the stock and debt approach is removed. Staff’s proposal is to the immediate right.]</p>	<p>Proposed staff revision (to replace all of Chapter 4):</p> <p>Value indicators are the evidences of market value prepared by the appraiser in support of the final value conclusion. Each year, as prescribed in rule 902, staff develops unitary value indicators that are used by the Board in reaching its unitary value determinations. Staff also recommends annual values for state assessees’ other property located in California, that is, nonunitary property, operating nonunitary property, and nonunitary rail transportation property.</p> <p>Under rule 3 there are five indicators of market value, or value approaches, one or more of which must be considered in property tax valuation:</p> <p>a) The price or prices at which the subject property or comparable properties have recently sold (the comparative sales approach)</p> <p>b) The prices at which fractional equity interests in the subject property or comparable properties have recently sold, and the extent to which such prices would have been increased had there been no prior debt claims on the assets (the stock and debt approach)</p> <p>c) The cost of replacing reproducible property with new property of similar utility, or of reproducing the property at its present site and at present price levels, less the extent to which the value has been reduced by depreciation (the replacement and reproduction cost approaches, respectively)</p> <p>d) If the income from the property is regulated by law and the regulatory agency uses historical cost or historical cost less depreciation as a rate base, the amount invested in the property or the amount invested less depreciation computed by the method employed by the regulatory agency (the historical cost approach)</p> <p>e) The amount that investors would be willing to pay for the right to receive the income that the property would be expected to yield, with the risks attendant upon its receipt (the income approach)</p>

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					<p>Related specifically to the valuation of unitary property, staff of the Board's Valuation Division has recently developed and published Unitary Valuation Methods, a publication that describes the valuation models (i.e., valuation approaches) used by staff in its preparation of unitary value indicators. In addition, as also prescribed in rule 902, Valuation Division staff conducts and publishes an annual capitalization rate study that develops capitalization rates used in the Board's capitalized earnings ability model.^(FN)</p> <p>Descriptions of the valuation models contained in Unitary Valuation Methods and the methods of capitalization rate derivation described in the annual capitalization rate study are not repeated in this manual; instead, the reader is referred to those publications. The reader also is referred to Assessors' Handbook Section 501, <i>Basic Appraisal</i>, and Section 502, <i>Advanced Appraisal</i>, publications containing discussions of general valuation principles and methods, much of which is generally applicable to the valuation of public utility property.</p> <hr/> <p>^(FN) Both <i>Unitary Valuation Methods</i> and the annual capitalization rate study are available from the Board.</p>
17.	23:26 & 30:45	All All	WSATR	See attached Addendum A for proposed revision.	See staff's proposed revision in item 16.
18.	27	2:8	WSATR	<p>Revise paragraph:</p> <p>The stock and debt approach is based on the fundamental accounting equation that assets equal liabilities plus owner's equity, but The methodology substitutes market values the prices of publicly traded debt and equity securities for accounting values. The idea is straightforward: that for publicly traded firms the prices paid for financial instruments in the capital markets can be used to determine the market values of the firm's total liabilities and owner's equity, which when are estimated and then added together to form an estimate of the market value of the firm's assets. If the firm is publicly traded, current prices of its securities as traded in the capital market can be used to value the liabilities and owner's equity. In essence, <u>all</u> of the firm's assets are valued indirectly through the capital market by valuing the financial claims against them.</p>	See staff's proposed revision in item 16.

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19.	28	3:6	WSATR	<p>Revise paragraph:</p> <p>Whether U.S. capital markets are efficient has been, and continues to be, the subject of much research and debate <u>with support on both sides</u>. There is considerable research evidence, however, demonstrating that U.S. capital markets are highly efficient and, therefore, that prices in U.S. capital markets can be trusted to represent fair market values.¹⁰ <u>That said, the fair market values reflected in the capital markets relate to the value of a firm in total and may be of little use in reflecting the value of the property plant and equipment owned by a firm.</u></p>	See staff's proposed revision in item 16.
20.	28	8:24	WSATR	<p>Revise paragraphs & add footnote:</p> <p>Although straightforward in concept, in practice the stock and debt approach involves several <u>is seldom useful in determining the value of the property that is subject to taxation</u>. Notable are the limited applicability of the approach, and the issue of control premiums, <u>and the need to recognize discounts for the higher risk of owning illiquid property, plant, and equipment.</u></p> <p>An obvious limitation of the stock and debt approach is that it cannot be applied to value the property of a firm whose common stock is not publicly traded or is thinly traded. <u>This includes firms that are subsidiaries of parent corporations that have publicly traded securities because it is generally not feasible to determine the portion of a parent company's stock price that is attributable to individual subsidiaries.</u> This limitation is not as severe, however, with non-traded or thinly traded debt issues or with preferred stock. Since these types of securities typically provide fixed payouts, the appraiser can value them by discounting the future promised payments at the yield rate prevailing on traded securities of equivalent risk.</p> <p>The stock and debt indicator is based on sales prices of minority interests and does not reflect any <u>a</u> "control premium" that may exist. There are many reasons why a buyer might offer a premium to existing shareholders to acquire a controlling interest, but economically, they all boil down to this: <u>However, in most instances the buyer thinks believes</u> the cash flow and resulting value of the firm's assets can be increased if the firm is under the buyer's control. <u>This is frequently based upon the circumstances of a particular buyer, and that buyer's ability to combine assets of the acquired firm with those of existing businesses that together have greater earning power than either</u></p>	See staff's proposed revision in item 16.

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			<p>would have standing alone. Under such circumstances a premium for control would not necessarily be indicative of market value since the premium paid may be related to the unique position of the actual purchaser instead of the typical buyer. In the absence of a visible takeover bid, however, determining The determination that a control premium exists and estimating its amount are skills more in the realm of investment banking and mergers and acquisitions analysis than appraisal. Few appraisers are experts in the market for corporate control.</p> <p><u>The prices paid for highly liquid stock and debt securities is not necessarily indicative of the value of the actual property, plant and equipment owned by the firm. This is the case because unlike the securities markets in which ownership interests can be sold on a moments notice the sale of tangible property frequently requires a lengthy process that may entail months or even years to secure a fair market price for the property. As a result, the prices paid for financial securities must be adjusted to reflect the added risk of holding, and if necessary selling, the tangible property. This is referred to as a discount for liquidity or lack there of, and similar to the control issue discussed above is more in the realm of investment banking, and mergers and acquisition analysis.</u>^{FN}</p> <hr/> <p>^{FN} Pratt, Shannon P., Reilly, Robert F., Schweih, Robert P. <u>Valuing a Business, The Analysis and Appraisal of Closely Held Companies, Third Edition, Irwin Professional Publishing, pg. 333</u></p>	
21.	28	31	<p>WSATR</p> <p>Revise paragraph:</p> <p>Nontaxable Property and Property Assessed Elsewhere. The value of property that is exempt from taxation (including the value of intangible assets and rights <u>such as trademarks, customer base, patents and copyrights, contracts, business affiliations etc. that are generally not on companies' balance sheets</u>) or the value of property that is taxed in a different manner may be included in the initial stock and debt indicator. The value of such property must be excluded from the final stock and debt value indicator.</p>	See staff's proposed revision in item 16.
22.	30	19:23	<p>O'Melveny & Myers L.L.P.</p> <p>Delete paragraph:</p> <p>In a unitary appraisal, the property being valued is the operating system. To create an operating system requires significant start-</p>	See staff's proposed revision in item 16.

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				up costs — that is, costs incurred prior to the production of revenue that cannot be identified with a specific tangible asset. Start-up costs are a valid component of the total cost of the operating system because the system could not be reproduced or replaced without incurring them.	
23.	55	2:6	Sacramento County Assessor's Office	Question. No alternative text provided. If during the limbo period an assessment appeal is filed on the property, who has jurisdiction to hear the appeal? If you say the local AAB has jurisdiction, then under what R&T code section gives the local board that authority?	See final paragraph of staff's proposed revision in item 26.
24.	55	2:6	SBE staff		Proposed staff revision (numbers list for clarity): The <u>This</u> chapter discusses appeals of state assessments. Under sections 731 and following, a state assessee or its designated representative may request a review of <u>(1)</u> the value of its unitary and/or nonunitary property and any related penalty assessments; <u>(2)</u> the allocation of the unit value of its unitary property among counties; and <u>(3)</u> the results of a Board audit resulting in escape assessments. The Board sits as the administrative appeals body for state assessments.
25.	57	11:13	WSATR	Question. No alternative text provided. Section 758 deals with escaped property or roll corrections – why is it cited as support in this part of the draft?	Proposed staff revision (correct citations): Under section 758 <u>733 and 759</u> , the assessment will become final if either a declaration of intent or a petition of reassessment is not filed within 20 days of the mailing date of the Board's notice of value.
26.	68 69	25:32 1:3	Sacramento County Assessor's Office	Question. No alternative text provided. Does the Assessor have any authority to continue assessing state-assessed property on the local roll during the "limbo period" between discovery and the jurisdictional switch? There appears to be no constitutional authority for us to continue assessing such property once it is discovered and, in Sacramento County at any rate, it has been our practice to remove from the local roll any such discoveries.	Proposed staff revision (revises existing text to answer the question posed): Property purchased by a state assessee from a local assessee is subject to Board assessment jurisdiction as of the date of transfer. The local <u>county</u> assessor should notify the Board of the transfer and remove the property from the local assessment roll <u>on the following lien date. During the period the property remains on the local roll, it is assessed in accordance with article XIII A.</u> The Board will assess the property on the next following lien date, in accordance with subdivision (b) of section 722.5: [R]eal property that becomes subject to board assessment on or after January 1, and on or

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					<p>before the following January 1, shall not be state assessed until the assessment year commencing on the latter January 1.</p> <p>The property comes under state jurisdiction on the date of the transfer even though it will not be assessed by the Board until the ensuing following January 1. Since it is under state jurisdiction, neither the change in ownership nor any subsequent new construction is subject to supplemental assessment.</p> <p><u>Even though the property will not be assessed by the Board until the following January 1, it comes under state jurisdiction on the date of the change in ownership. After the property becomes subject to state assessment, the county assessor has no authority to make any new assessment regarding the property. Thus neither the change in ownership itself nor any subsequent new construction (i.e., new construction that occurs between the date of transfer and the following lien date) is subject to supplemental assessment by the county assessor. Section 75.14 states in part "A supplemental assessment pursuant to this chapter shall not be made for any property not subject to the assessment limitations of Article XIII A of the California Constitution." Since a new base year value under Article XIII A is not established on property transferred to a state assessee, no supplemental assessment can occur.</u></p> <p><u>A question may also arise regarding assessment appeals jurisdiction. If an assessee files an appeal during the period after a locally assessed property becomes subject to state assessment but before the property is assessed on the board roll, the issue on appeal would relate to the prior assessment. Since that assessment was made on the local roll at a time when the property was subject to local assessment, the local appeals board would have jurisdiction. Contrariwise, if the issue on appeal relates to an assessment made on the board roll after the property became subject to state assessment, the Board of Equalization would have appeals jurisdiction.</u></p>
27.	68 69	25:32 1:3	Sacramento County Assessor's Office	<p>Question. No alternative text provided.</p> <p>If BOE wants us to leave the property on the local roll until BOE assumes jurisdiction, then under what methodology is the Assessor supposed to assess the property during the lull between discovery and the jurisdictional switch? Should the Assessor</p>	See staff's proposed revision in item 26.

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				continue assessing the property under Proposition 13, or at full market as required by the Constitution for a state-assessed property?	
28.	68 69	25:32 1:3	Sacramento County Assessor's Office	Question. No alternative text provided. If the property became assessable as the result of a change in ownership, should the Assessor issue a supplemental assessment even though we know the property should be state-assessed? If yes, under what authority?	See staff's proposed revision in item 26.
29.	68 69	25:32 1:3	Sacramento County Assessor's Office	Question. No alternative text provided. Where building permits have been issued before or during the limbo period, does the Assessor process and assess building permits as we normally might, including the issuance of new construction supplemental assessments? If yes, under what authority?	See staff's proposed revision in item 26.
30.	68 69	25:32 1:3	Sacramento County Assessor's Office	Question. No alternative text provided. If the Assessor continues to assess the property on the local roll (under any methodology) during the limbo period, does the BOE issue escape assessments/refunds for the difference between the local roll value and state-assessed value for the period between the actual point in time the property became assessable by the state and the date state assessment actually commenced?	See staff's proposed revision in item 26.
31.	68 69	25:32 1:3	Sacramento County Assessor's Office	Question. No alternative text provided. If the Assessor stops assessing the property on the local roll during the limbo period, will the BOE escape-assess those years during which the property was not being assessed?	See staff's proposed revision in item 26.
32.	69	26:31	SBE staff		Proposed staff revision (clarification and accuracy): In a typical sale-leaseback transaction, the sale and leaseback are essentially simultaneous. In a sale-leaseback involving a state assessee, the state assessee owner-seller, immediately becomes the lessee. There is generally no change in assessment jurisdiction, since all property owned or <i>used</i> (i.e., leased) by a state assessee is subject to state assessment. The property remains state <u>assessed even though the state assessee is merely leasing it</u> , unless the agreement specifies that not all of the property is leased to the state assessee, and the purchaser/lessor is to pay the property taxes. <u>Article XIII section 19 states that "the Board may delegate to a local assessor the duty to assess a property used but not owned by a state assessee on which the taxes are to be paid by the local assessee."</u>

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33.	69 70	34:35 1:6	SBE staff		<p>Proposed staff revision (clarification and accuracy):</p> <p><u>Generally, a change in ownership of the underlying fee interest (i.e., the lessor's interest) in a local assessee-owned but state-assessed property (i.e., the property is leased to a state assessee) does not change the assessment jurisdiction. Since the property remains leased to a state assessee it remains under Board jurisdiction.</u></p> <p>No action should be taken by the county assessor. Theis true even if the remaining term of the lease is less than 35 years; in which case, if the property were under local assessment jurisdiction, there would be a change in ownership. However, because the property remains under state assessment jurisdiction, it is not subject to the change in ownership provisions of article XIII A.</p> <p><u>Since the Board may delegate to the assessor the duty to assess property that is "used" but not "owned" by a state assessee and on which the taxes are paid by the local assessee, such delegation generally occurs for buildings and leasehold improvements that are "partially" leased and/or occupied by state assessees. The Board may not however, delegate the assessment of any portion of a state assessee's improvements, including leasehold improvements, if they are "owned" by the state assessee.</u></p>
34.	70	28:36	WSATR	<p>Comment. No alternative text provided.</p> <p>If a state assessee rents 2 square feet of space on an acre parcel of land or on the side of a building owned by a local assessee to mount a receiver or some other electronic device, this would be a foreign improvement. It seems unrealistic for the Board to value the entire acre parcel of land or the entire building. The statement that "the land is undoubtedly leased by the state assessee" and therefore, the land should be valued by the Board seems overreaching.</p>	<p>Proposed staff revision (attempts to answer question posed):</p> <p>For the purpose here, improvements owned by one party that are located on land owned by another party are called "foreign improvements" (in other contexts they might also be referred to as leasehold improvements or tenant improvements). If owned by a local assessee, and not leased to a state assessee, foreign improvements on state assessed land are subject to local assessment jurisdiction. The local assessor should assess such foreign improvements as any other property in the assessor's jurisdiction under the provisions of article XIII A.</p> <p>In the case of foreign improvements owned by a state assessee and land owned by a local assessee, both land and improvements are state assessed—the improvements because they are owned by a state assessee and the land because it is undoubtedly leased by the state assessee.</p> <p><u>In assessment, improvements owned by one party and located on</u></p>

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				<p><u>land owned by another party are called “foreign improvements.” For example, leasehold improvements owned by a lessee/tenant are a type of foreign improvement.</u></p> <p><u>Local assessee-owned foreign improvements on state-assessed land are subject to local assessment if the improvements are not used by (i.e., leased by) the state assessee. The county assessor should assess such improvements as he or she assesses other locally assessed property.</u></p> <p><u>In the case of state assessee-owned foreign improvements on land owned by a local assessee, both the improvements and the land are state assessed—the improvements because they are owned by the state assessee and the land because it would be leased by the state assessee.</u></p> <p><u>When a state assessee leases less than 100% of a local assessee-owned property (e.g., a portion of an office building) and the taxes are paid by the local assessee, the Board delegates its authority to assess the property to the county assessor. As discussed above however, the assessment of “state-assessee-owned” leasehold improvements located in such a property may not be delegated. Under Article XIII, section 19, the Board retains its authority to assess the state-assessee-owned leasehold improvements, and such improvements should not be assessed by the county assessor. If, for example, a local assessee landowner leases a portion of his property to a state-assessed cellular telephone company on which it constructs a cell tower, the Board has assessment jurisdiction over the cell tower (owned by the company), and the portion of the parcel that is leased and used by the state assessee.</u></p>
35.	88	O'Melveny & Myers L.L.P.	<p>Comment. No alternative text provided.</p> <p>The draft AH 541 includes a summary of applicable cases. The Board should consider adding a summary of its significant recent administrative decisions, such as those involving the valuation of the property of cellular companies where significant intangible assets are present, and the property treatment of telephone switch software as non-taxable property. We are available to assist in the compilation of such a summary.</p>	Not accepted (administrative decisions do not establish legal precedence for either the existing or a future Board).
36.	93	WSATR	<p>Revise definition:</p> <p>Accelerated Depreciation</p> <p>A method of accruing greater depreciation expense in the early</p>	<p>Proposed staff revision:</p> <p>Accelerated Depreciation</p> <p>A method of accruing greater depreciation expense in the early</p>

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			years of a property's life and less in the later years. Two methods of accelerated depreciation are (1) sum of the year's digits and (2) declining balance. One method of accelerated depreciation is the double declining balance method.	years of a property's life and less in the later years. Two methods of accelerated depreciation are (1) sum of the year's digits and (2) declining balance.
37.	93	WSATR	<p>Revise definition:</p> <p>Accumulated Depreciation</p> <p>(1) The difference between the reproduction or replacement cost of improvements and the market value of the improvements on a given date. (Appraisal concept.)</p> <p>(2) The amount reserved each year or accumulated to date for the replacement of an asset. (Accounting concept.) <u>of depreciation reserved each year is not "Accumulated Depreciation". The amount of periodic depreciation accumulated to date, i.e., the sum of the annual periodic reserves for depreciation, is accumulated depreciation.</u></p>	<p>Proposed staff revision (to replace entire existing definition):</p> <p>Accumulated Depreciation</p> <p>The total depreciation recorded on, or charged against, an asset since its acquisition; a contra account deducted from the original cost of an asset on the balance sheet.</p>
38.	93	WSATR	<p>Revise definition:</p> <p>Allowance for funds used during construction (AFUDC)</p> <p>The process of capitalizing the interest expense, or cost of funds, used during the construction of a project. The capitalized interest becomes part of the cost of the project. AFUDC is a component of construction cost for capital projects representing the net cost of debt and equity used during the period of construction.</p>	<p>Proposed staff revision (to replace entire existing definition):</p> <p>Allowance for funds used during construction (AFUDC)</p> <p>A component of construction cost for a capital project representing the cost of financing the project during its construction.</p>
39.	94	SBE staff	<p>Revise definition:</p> <p>Book Depreciation</p> <p>The total accruals recorded on the books of the property owner property summarizing the systematic and periodic expenses charged toward amortizing a capital investment over its expected limited life.</p>	<p>Proposed staff revision:</p> <p>Delete entire definition. This is not a generally accepted term.</p>
40.	94	WSATR	<p>Revise definition:</p> <p>Book Value</p> <p>Capitalized, or book, cost less <u>accumulated</u> accounting depreciation.</p>	<p>Proposed staff revision:</p> <p>Book Value <u>of an Asset</u></p> <p>Capitalized, or book, cost of an asset less <u>its accumulated</u> (accounting) depreciation.</p>
41.	94	WSATR	<p>Revise definition:</p> <p>Cash Flow</p>	<p>Proposed staff revision (to replace entire existing definition):</p> <p>Cash Flow</p>

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			The periodic income attributable to a given interest in real property; the cash generated by a business entity. Black's Law Dictionary: "The cash generated from property, business, etc. It is different from net income; cash flow looks to the amount of cash left after all payments are made, whether they are tax deductible or not. Cash receipts minus disbursements form a given asset, or group of assets, for a given period. An analysis of the movement of cash through a venture as contrasted with the earnings of the venture."	The cash receipts and cash expenditures associated with a project or investment.
42.	95	SBE staff	Revise sentence: Compound Interest and Annuity Tables Six sets of factors (or coefficients) that embrace the fundamentals of the mathematics of finance. The various factors <u>here</u> are here called Present Worth of 1, Present Worth of 1 per Annum, Future Worth of 1, Future Worth of 1 per Annum, Sinking Fund, and Mortgage Repayment.	Proposed staff revision: Delete entire definition. Not necessary.
43.	95	WASTR	Revise title: <u>Deferred Charges/Debits</u> Miscellaneous long term prepayments. Often a catchall account for items that do not fit into any other asset category and are not material enough individually to constitute a separate category.	Proposed staff revision: Delete entire definition. Not necessary.
44.	96	WSATR	Revise definition: Depreciation <u>Accounting Depreciation: A system of accounting intended to distribute the cost of tangible capital assets, less salvage (if any), over the estimated useful life of the unit in a systematic and rational manner.</u> A decrease in utility resulting in a loss in property value; the difference between estimated replacement or reproduction cost new as of a given date and market value as of the same date. There are three principle categories of depreciation, described below: (1) Physical Depreciation. The loss in utility and value due to some physical deterioration in the property; considered curable if the cost to cure it is equal to or less than the value added by curing it.	Proposed staff revision: Depreciation <u>In accounting: the expense charged to amortize the historical cost of an asset over its useful life; the allocation of the historical cost of an asset to the accounting periods over which the asset provides economic benefits</u> <u>In valuation or appraisal: a decrease in utility resulting in a loss in property value; the difference between estimated replacement or reproduction cost new as of a given date and market value as of the same date. There are three principle categories of depreciation identified in appraisal, described below:</u> (1) Physical Depreciation. The loss in utility and value due to some physical deterioration in the property; considered curable if the cost to cure it is equal to or less than the value added by curing it.

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			<p>(2) Functional Depreciation. The loss in utility and value due to changes in the desirability of the property; attributable to changes in tastes and style or the result of a poor original design. Functional obsolescence is curable if the cost to cure it is equal to or less than the value added by curing it.</p> <p>(3) External (or Economic) Obsolescence. The loss in utility and value due to an incurable defect caused by external negative influences outside the property itself; results from the immobility of real property.</p>	<p>(2) Functional Depreciation. The loss in utility and value due to changes in the desirability of the property; attributable to changes in tastes and style or the result of a poor original design. Functional obsolescence is curable if the cost to cure it is equal to or less than the value added by curing it.</p> <p>(3) External (or Economic) Obsolescence. The loss in utility and value due to an incurable defect caused by external negative influences outside the property itself; results from the immobility of real property.</p>
45.	97	WSATR	<p>Revise definition:</p> <p>Franchise</p> <p>A grant by a government agency authorizing the sale of product or service in a prescribed geographic area. In CA, the term franchise means a grant by a government agency permitting gas and electric utilities to use the public streets and highways for mains, pipes, etc. in the delivery of utility service. These franchises for energy utilities have nothing to do with "authorizing the sale of product or service in a prescribed geographical area.</p>	<p>Proposed staff revision (to replace entire existing definition):</p> <p>Franchise</p> <p>A privilege to do certain things not a common right of citizens generally that is conferred by government to an individual or corporation.</p>
46.	99	WSATR	<p>Revise definition:</p> <p>Net Operating Income</p> <p>The actual or anticipated net income that remains after all operating expenses are deducted from effective gross income but before mortgage debt service, <u>income taxes</u> and book depreciation are deducted.</p>	<p>Proposed staff revision:</p> <p>Delete entire definition.</p>
47.	100	WSATR	<p>Revise definition:</p> <p>Possessory Interests</p> <p>Interests in real property that exist as a result of (1) a possession of real property that is independent, durable and exclusive of rights held by others in the real property, and that provides a private benefit to the possessor, except when coupled with the ownership of a fee simple or life estate in the real property in the same person; or (2) A right to the possession of real property, or a claim to a right to the possession of real property, that is independent, durable and exclusive of rights held by others in the real property, and that provides a private benefit to the possessor, except when coupled with the ownership of a fee simple or life</p>	<p>Proposed staff revision:</p> <p>Delete entire definition (see "taxable possessory interest," in item 49).</p>

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			<p>estate in the real property in the same person; or (3) Taxable improvements on tax exempt land.</p> <p><u>Possessory interests are interests in real property that exist as a result of:</u></p> <p><u>(1) A possession of real property that is independent, durable, and exclusive of rights held by others in the real property, and that provides a private benefit to the possessor, except when coupled with ownership of a fee simple or life estate in the real property in the same person; or</u></p> <p><u>(2) A right to possession (actual physical occupation) of real property, or a claim to a right to the possession of real property, that is independent, durable, and exclusive of rights held by others in the real property, and that provides a private benefit to the possessor, except when coupled with ownership of a fee simple or life estate in the real property in the same person; or</u></p> <p><u>(3) Taxable improvements on exempt land.</u></p> <p><u>Refer to Rule 20 for full definition.</u></p>	
48.	100	WSATR	<p>Revise definition:</p> <p>Rate Base</p> <p>The dollar amount established by a regulatory agency on which a return is allowed. <u>Rate base is the historical cost of plant used or useful in providing service less accumulated depreciation less Accumulated Deferred Federal Income Taxes less Investment Tax Credits plus working capital.</u></p>	Not accepted. The original text is more general.
49.	101	WSATR	<p>Revise definition:</p> <p>Taxable Possessory Interest</p> <p>A private right to possession and use of publicly owned property for a period of time less than perpetuity. Taxable possessory interests are possessory interests in publicly-owned real property. <u>Excluded from the meaning of taxable possessory interests, however, are any possessory interests in real property located within an area to which the United States has exclusive jurisdiction concerning taxation. Such areas are commonly referred to as federal enclaves. (Rule 20 (b))</u></p>	Accept proposed revision.
50.	102	WSATR	<p>Revise definition:</p> <p>Unit Method of Valuation</p> <p>The technique of valuing a group of property items as "one</p>	Not accepted.

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				thing." <u>a collection of tangible assets functioning as an operating unit without reference to the separate values of the assets constituting the operating unit.</u>	
51.	102		WSATR	Revise definition: Yield Rate See basic capitalization rate. <u>May also be known as the basic capitalization rate.</u>	Agree, with slight modification: Yield Rate <u>In state assessment also known as basic capitalization rate; see</u> See basic capitalization rate.

Addendum A

(This is WSATR's proposed language. See items 16 and 17 of the matrix for staff's position.)

CHAPTER 4: UNITARY VALUE INDICATORS

Value indicators are the evidences of market value prepared by the appraiser in support of the final value conclusion. Each year, as prescribed in rule 902, staff develops unitary value indicators that are used by the Board in reaching its unitary value determinations. Staff also recommends annual values for state assessees' other property located in California, that is, nonunitary property, operating nonunitary rail transportation property. This chapter sets forth the general principles and procedures followed by the Board in the valuation of the unitary property of state assessees, focusing on the prescribed approaches to value in the context of public utility valuation.

Related specifically to the valuation of unitary property, staff of the Board's Valuation Division has recently developed and published the *Unitary Valuation Methods Book*, a document that describes in nuts-and-bolts fashion the valuation models (i.e., valuation approaches) currently used to prepare unitary value indicators. Although the models contained in the *Unitary Valuation Methods Book* will be discussed in this chapter, the reader is referred to that publication for significantly greater detail concerning them. Since the material concerning general valuation principles and methods contained in *Assessors' Handbook* Section, 501, "Basic Appraisal," and Section 502, "Advanced Appraisal," applies generally to the valuation of public utility property, the reader is also referred to those sections of the handbook.

Under rule 3 there are five indicators of market value, or value approaches, one or more of which must be considered in property tax valuation:

1. The price or prices at which the subject property or comparable properties have recently sold (*the comparative sales approach*)
2. The prices at which fractional equity interests in the subject property or comparable properties have recently sold, and the extent to which such prices would have been increased had there been no prior debt claims on the assets (*the stock and debt approach*)
3. The cost of replacing reproducible property with new property of similar utility, or of reproducing the property at its present site and at present price levels, less the extent to which the value has been reduced by depreciation (*the replacement and reproduction cost approaches, respectively*)
4. If the income from the property is regulated by law and the regulatory agency uses historical cost less depreciation less: DFIT as a rate base, the amount invested in the

property or the amount invested less depreciation less: DFIT computed by the method employed by the regulatory agency (*the historical cost approach*)

5. The amount that investors would be willing to pay for the right to receive the income that the property would be expected to yield, with the risks attendant upon its receipt (*the income approach*)

Historical Cost Less Depreciation (HCLD) Model

The Historical Cost Less Depreciation (HCLD) value indicator derivation includes the historical or original acquisition cost of all property less nontaxable items and property assessed elsewhere. This results in the taxable historical cost. The taxable historical cost is then reduced for the assessee's regulatory accounting depreciation of the taxable property. This results in the assessable HCLD. The value of any possessory interest and/or noncapitalization leased properties are added to arrive at the final HCLD value indicator.

HCLD is one of the more important indicators of value for closely regulated public utilities. The general practice of the California Public Utilities Commission (CPUC) and most other regulatory agencies is to use historical or original cost less depreciation (with various adjustments) as the rate base. The regulatory agencies establish a rate base and a rate of return; utilities are permitted to earn at this established rate on the rate base. Hence, it is logical that prospective buyers and sellers would see the rate base as a significant factor in formulating investment decisions. HCLD is much less important for valuing public utility properties that are not closely rate base regulated.

One of the major components in the development of the HCLD indicator is accounting depreciation. For most rate base regulated utilities, there may be several sets of accounting records that record depreciation. The set of records reflecting the depreciation (normally straight-line) allowed by the rate setting regulatory agency for rate or tariff-setting purposes is the proper depreciation figure to use for the HCLD.¹

Many utilities that are subject to central assessment are not closely regulated for economic results and therefore, do not maintain a depreciation reserve based on regulatory accounting rules. In such cases, an HCLD value indicator based on the assessee's book depreciation may be useful as a point of reference for establishing a relationship between net book value and market value. This indicator is generally not given any weight in the value reconciliation process, however as the use of HCLD is limited primarily to rate regulated utilities.

Appraisal depreciation in the form of obsolescence may be present in utility property and deducted from HCLD. Such deductions may be proper when the utility's economic income has been impaired and the rate or tariff-setting regulations have recognized such impairment.

¹ California Code of Regulations, Public Revenue, Title 18, Property Tax Rule 3 (d)

Since it is the practice of ratemaking agencies to deduct deferred income tax liabilities from the rate base, an adjustment for deferred income taxes is appropriate. Although a prospective purchaser would not necessarily expect to earn a return on the portion of the property represented by the deferred income tax liability, the prospective purchaser would expect to recover the cost of the investment through the depreciation allowances included in the rates. Therefore, the adjustment should measure the impairment on the utility's revenue, using the time value of money.²

Reproduction Cost Less Depreciation (Repro CLD) Model

The calculation of the Reproduction Cost Less Depreciation (ReproCLD) indicator is basically a two-step process. First, the reproduction cost new (ReproCN) is calculated by applying an index factor to the historical acquisition cost of property, segregated by year of acquisition. Second, the ReproCN is adjusted for normal depreciation by the application of a percent good factor to the ReproCN. The product of this calculation is the ReproCLD value indicator.

ReproCN is an estimate of the current cost to replace the existing property with a new property that is an *exact replica*, or virtually so, of the existing property. Data for the derivation of the ReproCN index factors can be obtained either from prices quoted by current vendors of the property or by applying an appropriate index factor to the historical or original acquisition cost of the property.³ The use of published index factors is the preferred method when performing mass appraisals for property tax purposes.

Numerous trade publications provide index factors for the conversion of historical cost to ReproCN. The publishers of these index factors generally survey industry participants and equipment manufacturers and compare current prices to a historical cost database. The ratio of price change for a given year is the ReproCN index factor. In addition to historical cost, these factors should also include an allowance for freight-in, installation, overhead during construction, and other indirect costs of placing a piece of property into productive and beneficial use.

For appraisal purposes, depreciation is defined as the loss in value due to any cause, including internal and external factors.⁴ Although depreciation that is calculated for the HCLD indicator follows the depreciation method(s) employed by the regulating authority this is not the case for the depreciation calculation used in the derivation of the ReproCLD indicator. For the ReproCLD indicator, depreciation is the difference in value between a new identical substitute property and the existing property. This difference is recognized as the complement to the percent good factors. The Valuation Division conducts service life studies to assist in determining the appropriate percent good factors.

The usefulness of the ReproCLD in the appraisal process depends on whether or not the market recognizes an exact replica of the subject property as having adequate utility for the operational needs of a contemporary business. If there are economical substitutes (i.e., a property of lower

² California State Board of Equalization, Assessor's Handbook 502, page 147

³ California Code of Regulations, Public Revenue, Title 18, Property Tax Rule 6(b) and 6 (c)

⁴ California State Board of Equalization, Assessor's Handbook 501, Chapter 6, Approaches to Value

cost or greater utility) for the property being appraised, the ReproCLD indicator may not be a reliable method to determine the fair market value of a subject property.

Replacement Cost Less Depreciation (ReplCLD) Model

The calculation of the Replacement Cost Less Depreciation (ReplCLD) indicator is basically a two step process. First, the replacement cost new (ReplCN) is calculated by applying an index factor to the historical acquisition cost of the property, segregated by year of acquisition. Second, the ReplCN is adjusted for depreciation by the application of a percent good factor to the ReplCN. The product of this calculation is the ReplCLD value indicator.

ReplCN is an estimate of the current cost to replace a property with new property of *equivalent utility*, of the existing property. The cost to replace a property should include all economic costs necessary to prepare the property for reproductive and beneficial use. The Valuation Division currently obtains information for the derivation of ReplCN index factors from two sources: (1) Studies provided by industry participants and (2), studies performed by the Policy, Planning, and Standards Division (PPSD) of the Property Taxes Department. The studies performed by PPSD are limited at present to general purpose computer equipment and peripherals. The use of index factors applied to historical cost data is the preferred method of calculating ReplCN for mass appraisal purposes. The historical costs of property is adjusted (in the aggregate or by groups) for replacement cost level changes by multiplying the cost incurred in a given year by the appropriate replacement cost index factor.

ReplCN should reflect the current cost a knowledgeable person or company would pay if it were to be necessary to replace the subject property with a new property of equivalent utility. ReplCN is an excellent starting point for estimating the value of new property not under rate of return regulation. This is because the property owner has the freedom, with competitive constraints, to adjust revenues to current costs based on market factors. Problems with the model include: (1) the difficulty in obtaining accurate replacement cost data, and (2) the subjectivity in selecting replacement property. These problems are minimized when the property to be appraised is relatively new.

While depreciation used for the HCLD indicator is the depreciation methods(s) employed by the regulatory authority, this is not the case in the depreciation calculation for the ReplCLD indicator. For the ReplCLD indicator, depreciation is the difference in value between a new substitute property of equivalent utility and the existing property. This difference is recognized as the complement to the percent good factors. The Valuation Division conducts service life studies to assist in determining the appropriate percent good factors.

The usefulness of the ReplCLD depends on, whether accurate data can be collected in order to determine a mathematical relationship between the cost of an older property and the cost of newer property. This relationship, expressed as a mathematical ratio, is the ReplCN index factor. If this information is not available, or there is no consensus in the marketplace as to what constitutes equivalent utility, the ReplCLD indicator may not be a preferred method to determine the fair market value of a subject property.

If an assessee properly and adequately documents additional or extraordinary obsolescence, it should be deducted from the ReplCLD value. Examples of acceptable methods to measure the amount of additional or extraordinary obsolescence include, under appropriate facts, the cost to cure the obsolescence and the present value of the excess costs of operation caused by the obsolete property.

Capitalized Earning Ability (CEA) Models

The capitalized earning ability or income approach to value is used when the property under appraisal is typically purchased in anticipation of a money income and either has an established income stream or can be attributed a real or hypothetical income stream by comparison with other properties. It is the preferred approach for the appraisal of properties when reliable sales data are not available and the cost approaches are unreliable because the reproducible property has suffered considerable physical depreciation, functional obsolescence or economic obsolescence, is a substantial over-or underimprovement, is misplaced or is subject to governmental restrictions on income that are unrelated to cost.⁵

The income approach to value may be generally described as any method that converts future anticipated income into present value. The conversion process is commonly known as income capitalization. The income approach is premised on the assumptions that investors will buy and sell property based on the income it is expected to yield and that investors will discount expected income as its attendant risk rate over its anticipated duration.⁶

Application of the income approach requires estimating future annual income for a period of time and converting income into a value estimate by means of a capitalization rate or present worth factor. The critical ingredients of the approach are the amount of anticipated future income, duration of income, capitalization rate, and method of capitalization.

The Valuation Division uses two basic CEA models. The primary model used by the staff assumes that individual assets are replaced as they are retired. Under the perpetual life concept, the capital investment necessary to maintain a perpetual income flow is deducted from expected revenues. With the necessary capital investment, the income stream is sustained into perpetuity.

In certain factual situations where it is determined that replacements to the property will not be made, a limited life model is used. The estimate of the remaining life should be based on physical factors. For example, the expected remaining life of a depleting oil field served by a pipeline would establish the estimate of remaining economic life for that pipeline. The limited life model involves forecasting an income stream for a finite period of time and discounting the periodic cash flows at an appropriate rate to arrive at the present value. Any remaining benefits at the end of the finite life are discounted to present value and added to the capitalized income. The limited life CEA is further divided into two premises based on the shape of the income stream: the level-annuity capital recovery premise and the straight-line decline capital recovery

⁵ California Code of Regulations, Public Revenue, Title 18 - Property Tax Rule 8

⁶ Assessor's Handbook 501, Chapter 6, pages 93-94.

premise. The level-annuity capital recovery is identical to a mortgage annuity payment, where the capital recovery begins at the lowest level at the beginning of the asset's life and grows as it ages. The straight-line decline capital recovery is similar to a straight-line depreciation, where the asset's recovery is the result of dividing its value equally over its estimated useful life. Care should be exercised by the appraiser in the selection of proper income stream premise. The level annuity capital recovery premise is not appropriate unless the prospective purchaser can reasonably expect that the level of revenue and expense anticipated will remain constant over the remaining life of the property.

The level of income capitalized in the level-annuity and the straight-line decline capital recovery models is the same. The capitalization rates are different to reflect the appropriate capital recovery premise.

In addition to the CEA models discussed above, staff calculates a Net Liquidation Value (NLV) indicator for certain state assessees where the degree of economic obsolescence is such that the highest and best use of the assets would be to sell the assets for liquidation value rather than operate the company as a going concern. Historically, staff has calculated NLV for many of the "short line" railroad state assessees. This value indicator becomes meaningful when it is greater than the capitalized value of the projected earnings from the property under its current use. Staff views the NLV as the minimum value indicator for a state assessee.

The NLV value indicator assumes that the subject of the appraisal is not a viable business operation and that the most prudent economic course of action is to cease operations and dispose of the assets. The result of the NLV calculation is the present worth of the anticipated proceeds to be derived by breaking up the appraisal unit and selling off the land, improvements and personal property over time. The estimated selling price of each category of property is discounted to present value based on the estimated time required to sell or liquidate the property. The amounts for each category are then added to arrive at the NLV indicator.

Sales Model

The sales model is a variation of the traditional comparative sales model. It differs from the latter because it uses the sales price of the subject directly, usually without comparing it to the sales of other comparable properties.

The comparative sales model is based on the principle of substitution.⁷ It assumes that the market value of property will approximate the sales price of competitive substitutes. It is the preferred method of valuation when reliable market data are available.⁸

⁷ Principle of Substitution: A reasonable purchaser will not pay more for a property than the cost of a substitution that can provide similar utility.

⁸ California Code of Regulations, Public Revenue, Title 18 - Property Tax Rule 4, the Comparative Sales Approach to Value.

In the case of the sale of utility, it is frequently difficult to apply the traditional comparative sales approach. There are several reasons contributing to the difficulty in using the traditional comparative sales approach:

- The uniqueness of each utility company.
- The size and the monopolistic/oligopolistic nature of utility companies making them less subject to sales.⁹
- The difficulty of obtaining information from different utility companies to make comparison feasible.

Even though there is weakness in a sales model utilizing few or no comparable sales, the model is a valid indicator of market value. The sales of a utility company is usually an arms-length transaction between a knowledgeable buyer and a knowledgeable seller. Extensive analyses generally are made by both parties with counsel from the best financial experts. Use of the sales Model in this manner is consistent with the Revenues and Taxation Code Section 110(b) and the Board of Equalization Rule 2(b).

⁹ Sales are more frequent with resellers in the telecommunications industry. In 1997, electric deregulation in California prompted the sale of many electric generation plants. It may be possible to apply the comparative sales approach to such sales.